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## California v. FCC: A Victory for the States

Ann E. Rendahl

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# ***California v. FCC: A Victory for the States***

by  
ANN E. RENDAHL\*

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## Introduction

The United States Court of Appeals for the Ninth Circuit has strengthened the power of state public utility commissions to regulate intrastate telecommunications services in its recent decision, *California v. FCC*.<sup>1</sup> In this decision, the court invalidated the Federal Communications Commission's (FCC's) *Computer III Order*,<sup>2</sup> a regulatory scheme that changed the way that the FCC would regulate "enhanced services," a computerized form of telecommunications service that allows electronic information to be modified, as well as transmitted.<sup>3</sup> More importantly, the court held that the FCC may not preempt state regulators from regulating purely intrastate enhanced services.

The *Computer III Order*, issued in 1986, was the FCC's third effort in twenty years to regulate the use of computers by the telecommunications industry. The FCC issued the *Computer III Order* just three weeks after the United States Supreme Court issued its decision in *Louisiana Public Service Commission v. FCC*.<sup>4</sup> This decision limited the FCC's authority under the Communications Act of 1934 (Communications Act or Act) to preempt state action.<sup>5</sup> Under the Communications Act, the FCC and the states share regulatory jurisdiction over the telecommunications industry. Sections 152(a) and (b) of the Communications Act establish a dual regulatory structure under which the FCC may regulate interstate telecommunications, while the states have jurisdiction over intrastate telecommunications. In *Louisiana Public Service*, the Supreme Court strictly interpreted these sections of the Communications Act to protect the states' authority to regulate intrastate services.<sup>6</sup>

The *Computer III Order* eliminated proven regulatory controls over enhanced services and preempted the states from regulating such services, even those offered on an intrastate basis. After unsuccessfully con-

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1. 905 F.2d 1217 (9th Cir. 1990).

2. *In re* Amendment of § 64.702 of the Commission's Rules and Regs. (Third Computer Inquiry), *Report and Order*, 60 Rad. Reg. 2d (P & F) 603 (1986) [hereinafter *Computer III Order*].

3. Enhanced services are defined as those "which employ computer processing applications that act on the format, content, code, protocol or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different, or restructured information; or involve subscriber interaction with stored information." 47 C.F.R. § 64.702(a) (1989). The FCC and state regulators differentiate between "basic services," e.g., the use of telephone lines for simple voice communication, and "enhanced services," since basic service is regulated as a monopoly telecommunication service, while enhanced service is capable of being offered as a competitive service and is "not suitable for regulation." Note, *Resale, Shared Use and De-regulation: Can the "Invisible Hand" Hold on to Ma Bell?*, 35 FED. COMM. L.J. 209, 209 (1983).

4. 476 U.S. 355 (1986).

5. 47 U.S.C. §§ 151-613 (1988).

6. *Louisiana Public Service*, 476 U.S. at 370-71.

testing the FCC's preemption order through the rulemaking process, the California Public Utilities Commission (CPUC) and other state regulatory agencies filed suit against the FCC to protect their authority under the Communications Act to regulate intrastate telecommunications services.<sup>7</sup> The state regulators challenged the FCC's interpretation of the Communications Act and raised the question of who should make decisions about telecommunications policy, or more specifically, who should regulate enhanced services. The Ninth Circuit's decision in *California v. FCC* guarantees, for the present, that state regulators will continue to determine intrastate telecommunications policy and establish the cost and quality of service for rate payers.

This Note focuses on the *Computer III Order*, particularly on the FCC's preemption order within this decision and the later Ninth Circuit decision rendering the *Computer III Order* invalid. Part I of this Note describes the regulatory events leading up to the FCC's *Computer III Order*, as well as its key elements. Part II of this Note discusses the Supreme Court's decision in *Louisiana Public Service*, which defines the limits of FCC preemption under the Communications Act. Part II also analyzes federal courts of appeals decisions preceding the Ninth Circuit's decision in *California v. FCC*.<sup>8</sup> This Note then presents the arguments of the litigants and analyzes the court's decision in *California v. FCC* in Part III. In Part IV, this Note recommends amendments to the Communications Act that may encourage consensus among state regulators and the FCC. Finally, in Part V, this Note concludes that state regulators, and ultimately consumers, have been best served by the Ninth Circuit's decision which found for the State of California and prohibited the FCC from preempting state regulation of intrastate enhanced services. Although *California v. FCC* presented the Ninth Circuit with a hard case, the court avoided making bad law by preserving the dual regulatory scheme established in the Communications Act.

## I

### Regulatory Background

In 1934, when Congress enacted the Communications Act, telephone companies offered simple voice communication service. Due to the lack of competition and the high cost of market entry, telecommuni-

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7. *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990).

8. *Public Util. Comm'n v. FCC*, 886 F.2d 1325 (D.C. Cir. 1989); *National Ass'n of Reg. Util. Comm'rs v. FCC*, 880 F.2d 422 (D.C. Cir. 1989); *Illinois Bell Tel. Co. v. FCC*, 883 F.2d 104, (D.C. Cir. 1989); *Hawaiian Tel. Co. v. Hawaii Pub. Util. Comm'n*, 827 F.2d 1264 (9th Cir. 1987), *cert. denied*, 487 U.S. 1218 (1988); *California v. FCC*, 798 F.2d 1515 (D.C. Cir. 1986).

cations service was considered to be a natural monopoly.<sup>9</sup> In order to protect consumers from price gouging and discriminatory practices by monopoly providers,<sup>10</sup> Congress authorized the FCC under the Communications Act "to regulate the price, availability, quality[,] and profitability"<sup>11</sup> of telecommunications services provided by common carriers.<sup>12</sup>

Under traditional rate of return regulation, a regulated company is guaranteed a return on its investments (e.g., facilities, lines, cables) but must provide the regulator with records of its earnings and reasonable costs of providing service.<sup>13</sup> After reviewing this information, the regulator determines the proper rates or tariffs<sup>14</sup> at which services are offered. Reasonable prices for consumers and a sufficient rate of return for investors are the goals of such regulation.<sup>15</sup> However, when a regulated company provides both unregulated and regulated services, the company has an opportunity to shift costs from the unregulated to the regulated service. This practice, known as cross-subsidization or cost-shifting, results in higher rates for the regulated service, and lower prices for the unregulated service, through which the company may undercut its competitors.<sup>16</sup> Telephone companies that provide both common carrier services (i.e., basic, regulated, telephone services) and noncommon carrier, or competitive, unregulated services, are able to shift costs more easily. The development of computer technology, which presented new ways for telecommunications companies to engage in cross-subsidization and predatory pricing, inspired the FCC to develop new rules to counter such activities.<sup>17</sup>

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9. McKenna, *Preemption Under the Communications Act*, 37 FED. COMM. L.J. 1, 18 (1985); Note, *The Computer Inquiries: Mapping the Communication/Information Processing Terrain*, 33 FED. COMM. L.J. 55, 58 (1981).

10. Note, *supra* note 9, at 58.

11. *Id.* at 55.

12. 47 U.S.C. §§ 151, 201-224 (1988).

13. Note, *supra* note 9, at 59-60.

14. "Tariffs include the times and conditions of service furnished and the prices to be charged based on a reasonable rate of return after payment of costs in providing the service." *Id.* at 70 n.44.

15. *Id.* at 60-61.

16. Note, *A Comparative Study of the Regulatory Treatment of Enhanced Services in the United States and the European Community*, 9 NW. J. INT'L L. & BUS. 415, 416 (1988); see Note, *supra* note 9, at 61-62. Tariffs for regulated services guarantee a company a certain rate of return. If a company also seeks to provide unregulated services, for which it must compete with others, the company may pay for some of the cost of the unregulated services with income from its regulated services, enabling it to keep the price of the unregulated services low. Thus, it becomes less risky for the company to provide unregulated services.

17. Note, *supra* note 16, at 416-17; see Note, *supra* note 9, at 64.

### A. The First Computer Inquiry

In 1966, the FCC initiated an inquiry as to whether "data processing, computer information, and message switching services, or any particular combination thereof" should be regulated under the Communications Act.<sup>18</sup> The FCC noted that computer and data processing companies were becoming dependent upon telecommunications to make their services widely available.<sup>19</sup> The FCC also noted that telecommunications common carriers were becoming dependent upon computers to provide more efficient service<sup>20</sup> and to provide new services that would be competitive with those offered by the computer and data processing companies.<sup>21</sup>

As a result, the FCC published the Tentative Decision,<sup>22</sup> stating that services which were clearly communications services would be regulated under Title II of the Communications Act, while services that involved data processing would be unregulated.<sup>23</sup> The FCC created definitional categories to determine whether a service would be regulated (telecommunications) or competitive (data-processing) and created hybrid categories.<sup>24</sup> In future cases, the FCC would decide on an ad hoc basis whether a service was a hybrid-communications or hybrid-data processing service.<sup>25</sup>

In addition to this definitional approach to regulation, the FCC determined that telecommunications common carriers would only be allowed to provide competitive data processing services through a separate subsidiary.<sup>26</sup> The FCC determined that only "maximum separation"

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18. *In re Regulatory and Policy Problems Presented by the Interdependence of Computer and Comm. Servs. and Facils., Notice of Inquiry*, 7 F.C.C.2d 11, para. 18 (1966) [hereinafter *Computer I Notice*].

19. *Id.* para. 1.

20. *Id.* para. 10. The interdependence of computer and communications services has been termed "communications," although this term has not been widely used. Note, *supra* note 9, at 63-64 (attributing the term to Anthony G. Oettinger, Director of Program Information Resources Policy at Harvard University).

21. *Id.* para. 15.

22. *In re Regulatory and Policy Problems Presented by the Interdependence of Computer and Comm. Servs. and Facils., Tentative Decision*, 28 F.C.C.2d 291 (1970) [hereinafter *Computer I Tentative Decision*], modified in *Final Decision and Order*, 28 F.C.C.2d 267 (1971) [hereinafter *Computer I Final Decision*], *aff'd in part sub nom. GTE Serv. Corp. v. FCC*, 474 F.2d 724 (2d Cir.), order on remand, 40 F.C.C.2d 293 (1973).

23. *Computer I Tentative Decision*, *supra* note 22, para. 20.

24. *Id.* para. 15. These definitions are codified at 47 C.F.R. § 64.702(a) (1989). *Computer I Final Decision*, 28 F.C.C.2d 267, Appendix A at 287 (1971).

25. *Computer I Final Decision*, *supra* note 22, paras. 25-27.

26. *Computer I Tentative Decision*, *supra* note 22, para. 36. The separate subsidiary would be required to hire separate officers and employees, maintain separate accounts, and prepare separate annual reports. *Id.* All agreements between the subsidiary and parent corporation would be reported to the FCC, and any communications services or facilities acquired by the

could prevent common carriers from engaging in cross subsidization, predatory pricing, and unfair competition.<sup>27</sup> The FCC determined that it was only necessary to apply this maximum separation policy to common carriers earning over one million dollars a year, but only the American Telephone & Telegraph Co. (AT&T) fell into this category.<sup>28</sup> However, such line drawing was irrelevant since AT&T and the Bell Operating Companies (BOCs) were already prohibited from providing competitive, non-common carrier services under a 1956 consent decree (Consent Decree).<sup>29</sup>

Although several telephone companies contested the FCC's actions, asserting that the FCC had no authority to regulate data processing services under the Communications Act,<sup>30</sup> the Second Circuit upheld *Computer I*.<sup>31</sup> However, the substantive regulations of *Computer I* created more problems for the FCC than did the issue of its authority under the Communications Act. The definitional approach and the hybrid category proved to be awkward to apply, and the FCC's ad hoc approach for hybrid services created a lengthy and unpredictable process for common carriers seeking to offer new services.<sup>32</sup>

## B. The Second Computer Inquiry

In 1976, recognizing that technological developments had outgrown the definitional approach of *Computer I*, the FCC initiated a second rulemaking proceeding concerning the interdependence of computers and communications.<sup>33</sup> In this proceeding, the FCC sought to develop a new definitional framework that would avoid the gray area of hybrid services<sup>34</sup> while maintaining a policy of maximum separation.<sup>35</sup> After five years of receiving and analyzing comments from industry representatives and state regulators, the FCC concluded that a definitional scheme that differentiated between regulated and unregulated services as "basic

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subsidiary from the parent would be subject to the same tariffs applicable to any other customer. *Id.*

27. *Id.* para. 35.

28. *Id.* para. 36.

29. *Id.* paras. 24, 43. In a 1956 antitrust action filed by the Justice Department against AT&T, AT&T and its affiliates were prohibited from manufacturing, selling, or engaging in any non-common carrier services. *United States v. Western Elec. Co.*, 1956 Trade Cas. (CCH) ¶ 68,246, at 71,137-38 (D.N.J. Jan. 24, 1956).

30. *Computer I Final Decision*, *supra* note 22, para. 5.

31. *GTE Serv. Corp. v. FCC*, 474 F.2d 724, 730 (2d Cir. 1973).

32. Note, *supra* note 9, at 64-66; Note, *supra* note 3, at 213, 223.

33. *In re Amendment of § 64.702 of the Commission's Rules and Regs., Notice of Inquiry and Proposed Rulemaking*, 61 F.C.C.2d 103, para. 8 (1976).

34. *Id.* para. 22.

35. *Id.* para. 15.



services" and "enhanced services" would be the most effective.<sup>36</sup> In addition, the FCC relieved all carriers except AT&T from compliance with the maximum separation requirement,<sup>37</sup> concluded that customer premises equipment<sup>38</sup> (CPE) should be deregulated and offered as a competitive service,<sup>39</sup> and determined that the Consent Decree did not prohibit AT&T from offering CPE or enhanced services.<sup>40</sup>

The FCC defined a "basic service" as "a pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information."<sup>41</sup> In plain English, basic services facilitate the transmission of information from one point to another. "Enhanced services," on the other hand, are any services other than basic services. The FCC defines enhanced services as those "which employ computer processing applications that act on the format, content, code, protocol[,] or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different, or restructured information; or involve subscriber interaction with stored information."<sup>42</sup> Automatic teller machines, electronic mail systems, voice messaging, and computerized data bases such as LEXIS and WESTLAW are common examples of enhanced services.<sup>43</sup> The FCC believed that these definitional categories would provide a more certain regulatory structure to common carriers and computer and data processing companies.<sup>44</sup>

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36. *In re* Amendment of § 64.702 of the Commission's Rules and Regs. (Second Computer Inquiry), *Final Decision*, 77 F.C.C.2d 384, paras. 5-7 (1980) [hereinafter *Computer II Final Decision*].

37. *Id.*, *Memorandum Opinion and Order*, 84 F.C.C.2d 50, paras. 64-71 (1980) [hereinafter *Computer II Reconsideration Order*].

38. Customer premises equipment is telecommunications equipment, provided by the carrier or a competitor, that is located on the customer's premises, *i.e.*, "the basic telephone, answering machines . . . and PBX [private branch exchange] switchboards." *Computer & Comm. Indus. Ass'n v. FCC*, 693 F.2d 198, 204 n.14 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983).

39. *Computer II Final Decision*, *supra* note 36, para. 9; *Computer II Reconsideration Order*, *supra* note 37, para. 46; *In re* Amendment of § 64.702 of the Commission's Rules and Regs. (Second Computer Inquiry), *Memorandum Opinion and Order on Further Reconsideration*, 88 F.C.C.2d 512, para. 3 (1981).

40. *Computer II Final Decision*, *supra* note 36, para. 13.

41. *Id.* para. 96.

42. *Id.* para. 5; *see* 47 C.F.R. § 64.702(a) (1989).

43. Note, *supra* note 16, at 415; *see* Brief for FCC at 7 n.7, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases). LEXIS® owned by Mead Data Central, Inc., and WESTLAW® owned by West Publishing Co., are databases that include federal and state court opinions, law review articles, and other legal research materials. A user can "go online" by keying a password into a computer terminal. The computer will automatically telephone the main database, and the user will have access to thousands of cases and other materials by putting in the necessary search words. Thus, an individual can access an amazing array of information by using a computer and a telephone line.

44. *Computer II Final Decision*, *supra* note 36, para. 42.

In addition to interpreting the Consent Decree to allow AT&T to offer enhanced services and CPE through structural separation, the FCC agreed that AT&T could petition the FCC for a waiver from the structural separation requirements if a certain enhanced service could only be offered "through network facilities" or if it would be too costly to provide the service through a separate subsidiary.<sup>45</sup> Although the FCC created a more concrete regulatory structure in *Computer II* than it had in *Computer I*, this decision was no more durable. Several parties, including the Department of Justice, contested the FCC's authority to enact such regulations.<sup>46</sup> The D.C. Circuit upheld the FCC's decisions in *Computer II*,<sup>47</sup> but The Department of Justice contested the FCC's interpretation of the Consent Decree in a New Jersey district court.<sup>48</sup>

### C. AT&T's Divestiture and the Modified Final Judgment

In 1982, while the appeal of *Computer II* was pending, Judge Greene of the D.C. Circuit approved a settlement, known as the Modified Final Judgment, in an antitrust suit brought against AT&T by the Department of Justice, which sought the divestiture of the BOCs and Western Electric from AT&T.<sup>49</sup> In the Modified Final Judgment, AT&T agreed to submit a reorganization plan for the divestiture of the BOCs from AT&T,<sup>50</sup> and in return, the Department of Justice agreed to release AT&T from the operating restrictions of the Consent Decree.<sup>51</sup>

Under the reorganization plan, AT&T divested itself of its twenty-two BOCs and reorganized them into seven regional holding companies.<sup>52</sup> Under the Modified Final Judgment, Judge Greene prohibited

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45. *Computer II Reconsideration Order*, *supra* note 37, para. 19.

46. Note, *supra* note 16, at 422.

47. *Computer & Comm. Indus. Ass'n v. FCC*, 693 F.2d 198, 203 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983).

48. Note, *supra* note 16, at 422; *see* *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131, 138 n.17 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983).

49. *American Tel. & Tel.*, 552 F. Supp. at 139. Although the bulk of the case represents Judge Greene's final judgment, for simplicity and in compliance with the practice of courts, this Note will refer to the decision as the Modified Final Judgment or the MFJ. *Id.* at 226.

50. *American Tel. & Tel.*, 552 F. Supp. at 226.

51. *Id.*

52. *See* AT&T Plan of Reorganization (filed Dec. 16, 1982), *approved in* *United States v. Western Elec. Co.*, 569 F. Supp. 990, 993 n.9 (D.D.C.), *aff'd sub nom. California v. United States*, 464 U.S. 1013 (1984). The seven regional holding companies, commonly known as the "RHCs," currently own 23 BOCs. TELECOM PUBLISHING GROUP, *INSIDE THE RHCs: A MANAGEMENT REPORT ON THE SEVEN REGIONAL HOLDING COMPANIES* (1987). However, as the FCC and others refer to the RHCs as the "BOCs," this Note uses the term BOCs. *Computer III Order*, *supra* note 2, para. 24 n.64.

AT&T from providing local exchange, or intra-LATA service,<sup>53</sup> and from entering the electronic publishing market for seven years.<sup>54</sup> The BOCs were prohibited from providing inter-LATA service,<sup>55</sup> manufacturing CPE, and engaging in certain businesses, including "information services," under broad line-of-business restrictions.<sup>56</sup> While Judge Greene approved many restrictions on the BOCs' activities, he left the FCC to decide whether to impose structural separation requirements on the new BOCs.<sup>57</sup> The FCC subsequently restricted the BOCs from providing CPE, enhanced services, and cellular services, except through separate subsidiaries,<sup>58</sup> conditioning these restrictions on the BOCs' ability to cross-subsidize, and noted that the FCC would review this decision in two years.<sup>59</sup>

However, as soon as the FCC acted, both the BOCs and AT&T sought relief from the structural separation requirements for providing CPE<sup>60</sup> and waivers from structural separation for enhanced services.<sup>61</sup> The waiver procedures of *Computer II*, combined with the break-up of AT&T, created more uncertainty in the regulatory environment rather than the stability the FCC expected from *Computer II*.<sup>62</sup>

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53. *American Tel. & Tel.*, 552 F. Supp. at 141. A "LATA" is similar to a local exchange and "stands for Local Access Transport Area, a term that describes the geographical areas . . . in which the BOCs provide service." *Computer III Order*, *supra* note 2, para. 24 n.65.

54. *American Tel. & Tel.*, 552 F. Supp. at 185-86.

55. *Id.* at 141, 188, 227.

56. *Id.* at 186, 189-91, 227. The Modified Final Judgment defines information services as "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information which may be conveyed via telecommunications, except that such service does not include any use of any such capability for the management, control, or operation of a telecommunications system or the management of a telecommunications service." *Id.* at 229. Judge Greene interprets information services and enhanced services to be "equivalent." *Id.* at 178 n.198.

57. *Id.* at 193 n.251; see *Computer III Order*, *supra* note 2, para. 27 n.72.

58. Policy and Rules Concerning the Furnishing of Customer Premises Equip., Enhanced Serv. and Cellular Comm. Equip. By the Bell Operating Cos., *Report and Order*, 95 F.C.C.2d 1117, para. 3 (1984) (BOC Separation Order), *aff'd sub nom.* Illinois Bell Tel. Co. v. FCC, 740 F.2d 465 (7th Cir. 1984); *Computer III Order*, *supra* note 2, para. 27.

59. *Computer III Order*, *supra* note 2, paras. 29-30. Judge Greene has lifted some of the line-of-business restrictions. As a result, the BOCs can now provide noncontent based information services. *Less Than Half a Loaf: Judge Greene Refuses to Unleash the Regional Holding Companies*, PUB. UTIL. FORT., Oct. 15, 1987, at 30.

60. *Computer III Order*, *supra* note 2, paras. 36, 39.

61. *Id.* paras. 33-38.

62. Note, *supra* note 16, at 425.

#### D. The Third Computer Inquiry

In response to the radical changes in the structure of the telecommunications market, the FCC's Third Computer Inquiry<sup>63</sup> in 1986 questioned whether structural separation was the best way to regulate common carrier activities under new market conditions.<sup>64</sup> On the basis of preliminary analysis which showed that the costs of structural separation outweighed the benefits,<sup>65</sup> and that structural separation had hindered the introduction of innovative services,<sup>66</sup> the FCC sought comments on its proposal to replace structural separation requirements with "non-structural safeguards" to prevent anti-competitive activity by AT&T and the BOCs.<sup>67</sup> Envisioning a more freely competitive market, the FCC proposed to make the entire telecommunications network open to all competitors through a program called "Comparably Efficient Interconnection."<sup>68</sup> Recognizing that basic services are the building blocks of enhanced services, the FCC proposed that carriers provide competitors "equal access" to their basic service networks through Comparably Efficient Interconnection in exchange for the ability to provide integrated, instead of separated, telecommunications services.<sup>69</sup>

##### 1. Open Network Architecture versus Comparably Efficient Interconnection

In the *Computer III Order*, the FCC announced Comparably Efficient Interconnection and Open Network Architecture as the short- and long-term means, respectively, for relieving AT&T and the BOCs from structural separation requirements and achieving the ultimate goal of a completely deregulated telecommunications market. The FCC envisioned Comparably Efficient Interconnection as the initial case-by-case means for allowing AT&T and the BOCs to offer integrated enhanced and basic services until the companies developed the more detailed Open Network Architecture plans.<sup>70</sup>

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63. *Computer III Order*, *supra* note 2; *Id.*, *Memorandum Opinion and Order on Reconsideration*, 2 FCC Rcd. 3035 (1987) [hereinafter *Phase I Reconsideration Order*]; *Report and Order*, 2 FCC Rcd. 3072 (1987) [hereinafter *Phase II Order*].

64. *In re Amendment of § 64.702 of the Commission's Rules and Regs. (Third Computer Inquiry)*, *Order*, 50 Fed. Reg. 33,581, paras. 18-19 (1985).

65. *Id.* para. 19.

66. *Id.* paras. 6-9.

67. *Id.* paras. 22, 120.

68. *Id.* paras. 116, 118-120.

69. *Id.* para. 120; *Computer III Order*, *supra* note 2, paras. 2, 44.

70. Note, *supra* note 16, at 426. Comparably Efficient Interconnection is a service-specific requirement. *Computer III Order*, *supra* note 2, para. 115. Under the FCC's Comparably Efficient Interconnection program, each time AT&T or the BOCs decide to offer a new enhanced service that uses their basic service facilities, the carriers must allow competitors "equal access." *Id.* para. 147. Equal access means that AT&T and the BOCs must allow competitors to use their basic services on an unbundled basis, provide competitors with techni-

Open Network Architecture is a much broader concept than Comparably Efficient Interconnection: It is the ultimate "equal access" plan.<sup>71</sup> The FCC defines Open Network Architecture as "the overall design of a carrier's basic network facilities and services to permit all users of the basic network, including the enhanced service operations of the carrier and its competitors, to interconnect to specific basic network functions and interfaces on an unbundled and 'equal access' basis."<sup>72</sup> While AT&T and the BOCs are required to file a Comparably Efficient Interconnection plan with the FCC before each enhanced service offering, once the FCC has approved a carrier's Open Network Architecture plan, the carrier may provide enhanced services on an integrated basis without submitting service specific plans.<sup>73</sup> The FCC has forged ahead with the Comparably Efficient Interconnection/Open Network Architecture program, despite the CPUC's appeal of *Computer III*.<sup>74</sup>

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cal specifications, and provide more than "rough comparability" in the quality and efficiency of interconnection. *Id.*; see *Phase I Reconsideration Order*, *supra* note 63, para. 92. The FCC seeks to have identical interconnection quality and efficiency but recognizes that equal access "does not demand impossible or grossly inefficient over-engineering of the network so that absolute equality is always achieved." *Id.*

Prior to offering each enhanced service, AT&T and the BOCs must file a Comparably Efficient Interconnection plan with the FCC for approval, describing how they will implement the Comparably Efficient Interconnection requirements. *Computer III Order*, *supra* note 2, para. 115. These plans are subject to public comment. *Id.* In addition to filing a Comparably Efficient Interconnection plan, AT&T and the BOCs must file cost allocation plans with the FCC that "properly allocate the joint and common costs created by their provision of enhanced services unseparated from their basic services." *Id.* paras. 226, 236. They must also disclose information to competitors about changes in their network at the same time that they inform their employees who market enhanced services. *Id.* para. 249. At the customer's request, AT&T and the BOCs must keep Customer Proprietary Network Information confidential or make it available to other enhanced services providers. *Id.* para. 262.

71. Fowler, Halprin & Schlichting, "Back to the Future": A Model for Telecommunications, 38 FED. COMM. L.J. 145, 191 (1986) [hereinafter Fowler].

72. *Computer III Order*, *supra* note 2, para. 113.

73. *Id.* para. 201.

74. AT&T and the BOCs were required to file plans with the FCC by February 1, 1988, describing in detail how they intended to implement Open Network Architecture. *Id.* para. 220. In November 1988, the FCC partly approved these plans, and directed the BOCs to file amended Open Network Architecture plans by May 19, 1989. *In re Filing and Review of Open Network Architecture Plans*, *Memorandum Opinion and Order*, 4 FCC Rcd. 1, paras. 1, 7-9 (1989). The FCC has approved amendments for several BOCs. See US West, Inc. Plan for Comparably Efficient Interconnection, *Memorandum Opinion and Order*, 4 FCC Rcd. 5512 (1989); South Cent. Bell Tel. Co. and S. Bell Tel. & Tel. Co. Plan for Comparably Efficient Interconnection, *Memorandum Opinion and Order*, 4 FCC Rcd. 6825 (1989). Also, on reconsideration, the FCC has modified the Open Network Architecture requirements for AT&T, allowing AT&T to continue to file Comparably Efficient Interconnection plans as it develops new enhanced services, rather than relying solely on an Open Network Architecture plan. *Phase I Reconsideration Order*, *supra* note 63, paras. 32, 48. The FCC has approved AT&T's Open Network Architecture plan and FCC approval of several AT&T Comparably Efficient Interconnection plans is pending. See *In re Filing and Review of Open Architecture Plans*, *Memorandum Opinion and Order*, 4 FCC Rcd. 2449 (1989); Pleading Cycle Established for

Through this program, the FCC changed its regulatory orientation and policies concerning the provision of enhanced services altogether. While the FCC's interest in removing structural separation requirements resulted in part from the divestiture of AT&T, it was spurred on by the move toward deregulation and free market economics. Applying classical microeconomic theory, several authors, including the former Chairman of the FCC, called for the removal of structural separation requirements and replacement by a competitive marketplace.<sup>75</sup>

The *Computer III Order* established that AT&T and the BOCs would be released from the structural separation requirements for providing enhanced services if they filed Comparably Efficient Interconnection and Open Network Architecture plans and complied with the FCC's non-structural safeguards (i.e., accounting, network disclosure, and customer proprietary network information (CPNI) requirements).<sup>76</sup> In addition, the FCC preempted state regulators from regulating intrastate enhanced services or imposing structural separation requirements or "inconsistent" nonstructural safeguards on intrastate services.<sup>77</sup>

The FCC made several arguments in the *Computer III Order* that do not necessarily follow from the facts the FCC provided.<sup>78</sup> First, the FCC stated that nonstructural safeguards would work just as well as structural separation requirements to prevent carriers from engaging in cross subsidization and discriminatory activity through the control of bottleneck facilities.<sup>79</sup> However, the FCC conceded in the *Computer III*

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Comments on AT&T's Comparably Efficient Interconnection Plan, *Public Notice*, 4 FCC Rcd. 5669 (1989); Pleading Cycle Established for Comments on AT&T's Petition for Waiver, *Public Notice*, 4 FCC Rcd. 6816 (1989).

75. See generally Lavey, *Ending Structural Separation for Telephone Companies*, 18 CONN. L. REV. 81 (1985); Fowler, *supra* note 71.

76. *Computer III Order*, *supra* note 2, paras. 3-5, 100. Although the FCC also considered the regulatory status of protocol processing, voice message storage services, and network channel terminating equipment in this proceeding, this Note focuses on the Comparably Efficient Interconnection/Open Network Architecture aspects of *Computer III* and the accompanying preemption order. *Id.* paras. 7-8. In its *Phase II Order*, the FCC concluded that Comparably Efficient Interconnection/Open Network Architecture requirements would not apply to the independent telephone companies, as they "lack the same potential as the BOCs to engage in anticompetitive conduct in the enhanced services marketplace." *Phase II Order*, *supra* note 63, paras. 9, 188 (1987).

77. *Computer III Order*, *supra* note 2, para. 334.

78. MCI Telecommunications Corp., a petitioner in *California v. FCC*, asserted that the FCC acted arbitrarily and capriciously in deciding the *Computer III Order*. See Supplemental Brief of Petitioners, MCI Telecomm. Corp. at 1 n.1, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases). The Ninth Circuit agreed and invalidated the order. *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990); see also *infra* notes 233-35 and accompanying text.

79. *Computer III Order*, *supra* note 2, paras. 77, 97. A "bottleneck" occurs where one common carrier controls the facilities that competitors require to provide communications or enhanced services to their customers. Note, *supra* note 16, at 417.

*Order* that the abilities and incentives of AT&T and the BOCs to engage in cross subsidization and anticompetitive activities had not diminished.<sup>80</sup>

Second, the FCC asserted that the costs of requiring carriers to maintain separate subsidiaries for enhanced services outweigh public benefits<sup>81</sup> but did not provide convincing quantitative data to support its arguments.<sup>82</sup> Third, while the FCC asserted that nonstructural safeguards would be self-enforcing,<sup>83</sup> it conceded that there were no guarantees that carriers would not discriminate or shift costs.<sup>84</sup> The FCC further asserted that in the event of abuses, its complaint process would resolve the problems.<sup>85</sup> Several intervenors protested that such a post hoc remedy would not be sufficient.<sup>86</sup>

Finally, the FCC asserted that this scheme would promote greater competition and result in more efficient and innovative services.<sup>87</sup> However, the FCC has two primary mandates under the Communications Act. The FCC must 1) provide the public with efficient service and 2) provide the service at reasonable cost to the ratepayers.<sup>88</sup> By recommending this deregulatory scheme, the FCC expressed its willingness to gamble with the ability of ratepayers to bear the costs of telecommunications services for its free market experiment,<sup>89</sup> and even admitted that the consumer would ultimately bear the cost.<sup>90</sup>

## 2. *The Preemption Order*

It is interesting to note that former FCC Chairman Fowler asserted in an article describing the Comparably Efficient Interconnection/Open Network Architecture proposal that "[t]his proposal is not designed to impose a federal view on the states."<sup>91</sup> Despite the Chairman's statement, the FCC preempted the states from regulating enhanced services in

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80. *Computer III Order*, *supra* note 2, paras. 83, 96, 193.

81. *Id.* paras. 3, 74, 98.

82. *Phase I Reconsideration Order*, *supra* note 63, paras. 14-15; see Lavey, *supra* note 75, at 103-04; see also Frieden, *The Third Computer Inquiry: A Deregulatory Dilemma*, 38 FED. COMM. L.J. 383, 387-88 (1987).

83. *Computer III Order*, *supra* note 2, para. 211.

84. As proof of the continued ability of the BOCs to cross-subsidize, the FCC recently fined two NYNEX companies for buying "equipment, services and supplies from another NYNEX subsidiary" at inflated prices and passing the cost on to customers. N.Y. Times, Feb. 9, 1990, at A1, col. 1 (nat'l ed.).

85. *Computer III Order*, *supra* note 2, para. 222.

86. *Phase I Reconsideration Order*, *supra* note 63, para. 57.

87. *Computer III Order*, *supra* note 2, paras. 76, 98.

88. 47 U.S.C. § 151 (1988).

89. Frieden, *supra* note 82, at 408.

90. *Computer III Order*, *supra* note 2, para. 171; Frieden, *supra* note 82, at 410.

91. Fowler, *supra* note 71, at 200.

*Computer III*. Although the *Computer III Order* was published nearly three weeks after the United States Supreme Court issued its decision in *Louisiana Public Service Commission v. FCC*,<sup>92</sup> which limited the FCC to regulating interstate activities, the FCC did not address the effects of *Louisiana Public Service* on its decision to preempt state regulation of intrastate enhanced services.

The FCC asserted that the states were preempted from regulating enhanced services under the D.C. Circuit's decision in *Computer and Communications Industry Association v. FCC*,<sup>93</sup> which upheld the FCC's findings in *Computer II* that enhanced services were not common carrier services and that the FCC could preempt state regulation of CPE and enhanced services. State regulators petitioned the FCC for reconsideration following the *Louisiana Public Service* decision, but the FCC affirmed its original decision to preempt the states.<sup>94</sup> After the rulemaking proceedings were final, the CPUC and other state regulatory commissions filed suit in the Ninth Circuit challenging the FCC's preemption order.

While the competitive, free market policy goals of the FCC were clearly at issue in *California v. FCC*,<sup>95</sup> the debate over *Computer III* has focused primarily on the legal issue of the FCC's preemptive power following *Louisiana Public Service*. The states are unlikely to persuade the FCC to change its policies; however, they have been able to limit the FCC's actions by retaining regulatory control over the intrastate activities of telephone companies.<sup>96</sup>

## II

### FCC Preemption and *Louisiana Public Service Commission v. FCC*

#### A. FCC Preemption Before *Louisiana Public Service*

The FCC and the states share regulatory authority over telecommunications under the Communications Act. The Communications Act grants the FCC power over "all interstate and foreign communication by wire or radio,"<sup>97</sup> and expressly denies the FCC authority over "charges,

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92. 476 U.S. 355 (1986).

93. 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983); *see Computer III Order*, *supra* note 2, paras. 343, 347-348.

94. *Phase I Reconsideration Order*, *supra* note 63, paras. 6, 173.

95. 905 F.2d 1217 (9th Cir. 1990).

96. *See California v. FCC*, 798 F.2d 1515 (D.C. Cir. 1986); National Ass'n of Reg. Util. Comm'rs v. FCC, 880 F.2d 422 (D.C. Cir. 1989); *see also infra* text accompanying notes 140-47, 160-78.

97. 47 U.S.C. § 152(a) (1988).



classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio."<sup>98</sup> These matters were left to the states. However, the telecommunications network performs both interstate and intrastate functions, and is not clearly delineated as either interstate or intrastate.<sup>99</sup> For many years, the regulatory philosophy of state regulators and the FCC was consistent, and the issue of jurisdiction rarely arose.<sup>100</sup> However, as the FCC began to promote policies of competitiveness and deregulation, this regulatory harmony unraveled and the states and the FCC have been involved in a turf battle ever since.<sup>101</sup> This conflict is not just over jurisdiction; the heart of the issue is regulatory philosophy.

The FCC has been successful in implementing its policies of competitiveness and deregulation. The ability of the FCC to preempt the states from implementing regulations that would impede these goals has been the key to its success.<sup>102</sup> The FCC has broadened its authority over telecommunications policymaking through several principal cases.

In *United States v. Southwestern Cable Co.*,<sup>103</sup> the Supreme Court found that the FCC had jurisdiction to regulate cable television under a theory that such jurisdiction was "reasonably ancillary to the effective performance of the Commission's various responsibilities for the regulation of television broadcasting" under Title III of the Communications Act.<sup>104</sup> The FCC has justified the extension of its regulatory jurisdiction by asserting "ancillary jurisdiction" through its broad mandate under section 151 of the Communications Act "to make available, so far as possible, to all the people of the United States a rapid, efficient, [n]ationwide, and worldwide wire and radio communications service."<sup>105</sup> While Title III specifically gives the FCC jurisdiction over broadcasting activities, section 151 is not a jurisdictional provision but a policy statement.

In the second case, *North Carolina Utilities Commission v. FCC*,<sup>106</sup> the FCC confronted the jurisdictional problems of section 152 but as-

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98. *Id.* § 152(b).

99. Haring & Levitz, *The Law and Economics of Federalism in Telecommunications*, 41 FED. COMM. L.J. 261, 295 (1989); McKenna, *supra* note 9, at 14-15, 58; McKenna, *Preemption Reversed: The Supreme Court's Decision in Louisiana Public Service Commission v. FCC*, 39 ADMIN L. REV. 43, 54-55 (1987).

100. Cain, *Constitutional Struggle Over Telecommunications Regulation*, 10 HASTINGS COMM/ENT L.J. 1, 6-7 (1987); Haring & Levitz, *supra* note 99, at 295.

101. Haring & Levitz, *supra* note 99, at 263, 296-97; McKenna, *supra* note 9, at 4.

102. McKenna, *supra* note 9, at 2; Miller, *Ideology, Jurisdiction, and Deregulation of the Telephone Network*, PUB. UTIL. FORT., Oct. 2, 1986, at 14, 15.

103. 392 U.S. 157 (1968).

104. *Id.* at 178.

105. 47 U.S.C. § 151 (1988).

106. 537 F.2d 787 (4th Cir.), *cert. denied*, 429 U.S. 1027 (1976).

serted that federal regulations preempted state regulations where the state rules thwarted the effectiveness of federal policy. The Fourth Circuit was receptive to the FCC's assertion, holding that the FCC could preempt the states from issuing regulations that would interfere with the federal policy of CPE interconnection provided by nontelephone companies.<sup>107</sup> The court held that section 152(b) limited the FCC's regulatory authority only as to "local services, facilities[,] and disputes that in their nature and effect are separable from and do not substantially affect the conduct or development of interstate communications."<sup>108</sup> The test developed by the Fourth Circuit became an effective tool with which the FCC could extend its regulatory authority. Several circuits adopted the test and applied it favorably to the FCC.<sup>109</sup>

The third case, *Computer and Communications Industry Association v. FCC*,<sup>110</sup> ("CCIA"), combined the theory of ancillary jurisdiction and the *North Carolina Utilities* exception to section 152(b), "producing a sweeping result of remarkable implications."<sup>111</sup> In that case, the FCC asserted, first, that it had authority to regulate CPE under ancillary jurisdiction, since CPE was not a common carrier service subject to Title II regulation. Second, the FCC argued that CPE was not severable as an intrastate or interstate facility under section 152(b).<sup>112</sup> The D.C. Circuit upheld both of the FCC's assertions in *CCIA*, and found that the FCC could also extend its jurisdiction to enhanced services.<sup>113</sup> Following *CCIA*, there was a belief that the FCC would never lose a preemption battle and that the FCC would continue to dictate national telecommunications policy.<sup>114</sup> However, the Supreme Court's decision in *Louisiana Public Service*<sup>115</sup> tempered that belief.

#### B. *Louisiana Public Service Commission v. FCC*

Soon after the D.C. Circuit approved the FCC's preemptive action in *CCIA*, the FCC issued an order preempting the states from requiring telephone companies to use depreciation methods which differed from

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107. *Id.* at 793.

108. *Id.*

109. Cain, *supra* note 100, at 10-15; McKenna, *supra* note 9, at 52; Phillips, *Federal Preemption of Conflicting Telecommunications Regulations*, 7 GLENDALE L. REV. 141, 152 (1987).

110. 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983); *see also supra* note 93 and accompanying text.

111. McKenna, *supra* note 9, at 39; McKenna, *supra* note 99, at 53.

112. *Computer II Final Decision*, *supra* note 36, paras. 172, 175, 184-189.

113. *Computer & Comm. Indus. Ass'n v. FCC*, 693 F.2d 198, 209-10, 213 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983); *see McKenna, supra* note 9, at 38-39.

114. McKenna, *supra* note 9, at 62.

115. 476 U.S. 355 (1986).

the method that the FCC had adopted. Seeking to encourage greater capital recovery within the telephone industry, the FCC changed the method of depreciating telephone plant.<sup>116</sup> State regulators sought review of the FCC's decision, claiming that the FCC was prohibited from regulating intrastate "charges" under section 152(b) of the Communications Act. The reviewing court upheld the FCC's preemption order, finding that section 152(b) did not bar FCC preemption.<sup>117</sup> The Fourth Circuit applied the *North Carolina Utilities* test and held that allowing the states to set different depreciation rules would "substantially affect" the federal policy of a more competitive telecommunications industry.<sup>118</sup> The Supreme Court granted certiorari and reversed.<sup>119</sup>

The Supreme Court made a cursory review of the FCC's policy arguments in its decision and asserted that "we do not assess the wisdom of the asserted federal policy of encouraging competition within the telecommunications industry."<sup>120</sup> The Supreme Court decided this case under traditional preemption analysis by looking at the Communications Act to determine "whether Congress intended that federal regulation supersede state law."<sup>121</sup> The Court focused its decision on sections 151 and 152 of the Act, as the FCC relied on the broad mandate of section 151 to justify preemption, and the states argued that section 152(b) established a dual regulatory system. The FCC also relied on section 220 of Title II of the Communications Act, under which the FCC can set depreciation rules and preempt inconsistent state depreciation practices.<sup>122</sup> The Court rejected the FCC's interpretation of the Communications Act, stating that "[b]y its terms, [section 152(b)] fences off from FCC reach or regulation intrastate matters . . . , including matters 'in connection with' intrastate service."<sup>123</sup> The Court held that "[section] 152(b) . . . contains not only a substantive jurisdictional limitation on the FCC's power, but also a rule of statutory construction" under which sections 151 and 152(b) do not conflict, but co-exist.<sup>124</sup> The Court also rejected the FCC's argument that section 220 preempted state regulation, stating that that section is subject to the jurisdictional limits of section 152.<sup>125</sup>

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116. *Id.* at 360. Telephone plant refers to the equipment that telephone companies own and use to operate the system, e.g., switching stations and telephone lines.

117. *Virginia State Corp. Comm'n v. FCC*, 737 F.2d 388 (4th Cir. 1984).

118. *Id.* at 392; Cain, *supra* note 100, at 17.

119. *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 359, 363 (1986).

120. *Id.* at 359.

121. *Id.* at 369.

122. *Id.* at 367-68.

123. *Id.* at 370.

124. *Id.* at 370, 373.

125. *Id.* at 376-78.

The Court did acknowledge the dilemma presented by section 152, stating that "the realities of technology and economics belie . . . a clean parceling of responsibility" between the FCC and the states.<sup>126</sup> However, the Court concluded that the Communications Act resolved this by providing a "jurisdictional separations" process in section 410(c).<sup>127</sup> Through this process, the FCC determines "what portion of an asset is employed to produce or deliver interstate as opposed to intrastate service."<sup>128</sup> The Court held that once the separation has been made, the states and the FCC are free to "apply different rates and methods of depreciation."<sup>129</sup>

The Court also rejected the FCC's argument under the *North Carolina Utilities* test that section 152(b) is only a bar to FCC preemption when the matter is "separable from and [does] not substantially affect . . . interstate communications."<sup>130</sup> The Court appeared to reject the *North Carolina Utilities* test when it stated that "this argument . . . misrepresents the statutory scheme and the basis and test for [pre]emption."<sup>131</sup> However, the Court later distinguished *North Carolina Utilities* from *Louisiana Public Service*, leaving the impression that at least part of the *North Carolina Utilities* test is still valid.<sup>132</sup>

Some commentators criticized the Supreme Court for its "literal" interpretation of the Communications Act,<sup>133</sup> fearing that the FCC's ability to implement its competitive policies would be limited.<sup>134</sup> The Court, possibly anticipating such a response, properly stated that "only Congress can rewrite this statute."<sup>135</sup> However, the Court did not hamstring the FCC by this decision. It left the FCC an important "out" in footnote four. In this footnote, the Court distinguished *North Carolina Utilities* from *Louisiana Public Service*, stating that "these cases are readily distinguishable from those in which FCC [pre]emption of state regulation was upheld where it was *not* possible to separate the interstate and the intrastate components of the asserted FCC regulation."<sup>136</sup> Thus, the

126. *Id.* at 360.

127. *Id.* at 375.

128. *Id.*

129. *Id.*

130. *North Carolina Utils. Comm'n v. FCC*, 537 F.2d 787, 793 (4th Cir.), *cert. denied*, 429 U.S. 1027 (1976); *Louisiana Pub. Serv.*, 476 U.S. at 374.

131. *Louisiana Pub. Serv.*, 476 U.S. at 374; McKenna, *supra* note 99, at 49-50.

132. *Louisiana Pub. Serv.*, 476 U.S. at 375 n.4; *see also* McKenna, *supra* note 99, at 51-52, 54; Phillips, *supra* note 109, at 158.

133. Haring & Levitz, *supra* note 99, at 310; Phillips, *supra* note 109, at 159.

134. Cain, *supra* note 100, at 23; Haring & Levitz, *supra* note 99, at 264, 313; McKenna, *supra* note 99, at 53; Miller, *supra* note 102, at 14, 16.

135. *Louisiana Pub. Serv.*, 476 U.S. at 376.

136. *Id.* at 375 n.4 (emphasis in original).

Court left the option open for the FCC to continue to preempt regulatory action by the states.<sup>137</sup> Despite dire predictions by commentators that *Louisiana Public Service* would limit the FCC's ability to implement its competitive policies,<sup>138</sup> the application of *Louisiana Public Service* and footnote four in the courts of appeals has proved that those fears were unfounded.<sup>139</sup>

### C. Subsequent Courts of Appeals Cases

#### 1. *California v. FCC—FM Subcarrier*

The first FCC preemption case to reach the federal courts of appeals following *Louisiana Public Service* was *California v. FCC*,<sup>140</sup> ("FM Subcarrier"). In *FM Subcarrier*, the FCC preempted state regulation of solely intrastate radio common carrier services provided on FM subcarrier frequencies on the basis that section 301 of Title III of the Communications Act, which establishes the FCC's authority over radio transmission, superseded the states' authority to regulate intrastate radio common carrier service under section 152(b).<sup>141</sup> In 1983, the FCC issued an order allowing common carriers and nonbroadcast services to use FM subchannels, effectively deregulating the subcarrier market.<sup>142</sup> Due to the suspicion that state regulators would use their licensing authority to prevent the entry of common carrier services into the interstate FM subcarrier market, the FCC issued a preemptive order.<sup>143</sup> However, this order extended the FCC's preemptive power to purely intrastate common carrier service on FM subchannels.<sup>144</sup>

Applying the Supreme Court's literal interpretation of section 152(b) in *Louisiana Public Service*, the D.C. Circuit reversed that portion of the FCC's order that preempted "purely intrastate radio common carriage."<sup>145</sup> The court held that the FCC had no authority to preempt state regulation of intrastate common carrier services merely because it would frustrate the FCC's policies.<sup>146</sup>

*FM Subcarrier* is a prime example of the FCC using its preemptive authority to prevent state regulation that would frustrate its free market

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137. Haring & Levitz, *supra* note 99, at 313-14; McKenna *supra* note 99, at 54; Phillips, *supra* note 109, at 166.

138. Cain, *supra* note 100, at 28, 30; Phillips, *supra* note 109, at 167.

139. Haring & Levitz, *supra* note 99, at 313, 322; Phillips, *supra* note 109, at 159.

140. 798 F.2d 1515 (D.C. Cir. 1986) (this case is commonly referred to as *FM Subcarrier*).

141. *Id.* at 1516-17.

142. *Id.* at 1517.

143. *Id.*

144. *Id.* at 1518.

145. *Id.* at 1520.

146. *Id.* at 1519.

policies. The D.C. Circuit aptly stated "[t]he Commission's logic would . . . prepare the way for the complete elimination of any state role in the regulation of intrastate radio common carriage. . . . [S]uch a result would reduce section 152(b) to a nullity, violating the congressional intent to establish a system of dual regulatory control . . . ." <sup>147</sup>

## 2. *Hawaiian Telephone Co. v. Hawaii Public Utilities Commission*

The Ninth Circuit was the second appellate court to hear an FCC preemption case following *Louisiana Public Service*. Until *California v. FCC, Hawaiian Telephone Co. v. Hawaii Public Utilities Commission* <sup>148</sup> was the only decision issued by the Ninth Circuit interpreting *Louisiana Public Service*. In *Hawaiian Telephone*, the FCC applied the same procedures for separating the costs of interstate from intrastate telephone plant <sup>149</sup> to Hawaii that it applied to telephone plant on the Mainland. <sup>150</sup> The Hawaiian Telephone Company (HawTel) made an agreement with the FCC and AT&T to phase in the new method by lowering interstate rates while raising intrastate rates. <sup>151</sup> Soon after the FCC issued an order adopting this plan, HawTel filed for an increase in local rates with the Hawaii Public Utilities Commission (HPUC). <sup>152</sup> The HPUC allowed only half of this increase. While an appeal of the HPUC's decision was pending in the state courts, HawTel sought another rate increase for the following year, and the HPUC again granted HawTel less than it had requested. <sup>153</sup> This time, HawTel sought relief in the federal courts, asserting that the HPUC had violated the FCC's separations order and that the FCC's order preempted the HPUC from applying its own separations procedures. <sup>154</sup>

The *Hawaiian Telephone* court held that the HPUC was preempted from applying a separations procedure for determining an intrastate rate base that was inconsistent with that adopted by the FCC. <sup>155</sup> The court interpreted *Louisiana Public Service* as providing that "it is only *after* a uniform separations formula has been applied that a state's independent depreciation rule for intrastate ratemaking can be protected from federal preemption." <sup>156</sup>

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147. *Id.*

148. *Hawaiian Tel. Co. v. Hawaii Pub. Utils. Comm'n*, 827 F.2d 1264 (9th Cir. 1987), *cert. denied*, 487 U.S. 1218 (1988).

149. See *supra* note 116 and accompanying text.

150. *Hawaiian Tel.*, 827 F.2d at 1266.

151. *Id.* at 1267.

152. *Id.*

153. *Id.* at 1267-68.

154. *Id.* at 1268, 1274.

155. *Id.* at 1276.

156. *Id.* (emphasis in original).

The dissent claimed that such a holding “misconstrues and misapplies” *Louisiana Public Service*, as it appears to disregard the states’ authority over intrastate ratemaking.<sup>157</sup> While the majority’s decision does seem to contradict *Louisiana Public Service*, it merely identifies an additional weakness in the Communications Act concerning the jurisdictional separations process, which, as the Supreme Court noted, only Congress may correct.

Although the Ninth Circuit decided *Hawaiian Telephone* by applying *Louisiana Public Service*, the case could have been resolved more precisely by applying the rules governing the jurisdictional separations process. Section 410(c) of the Communications Act provides for the creation of a Federal-State Joint Board to discuss the “jurisdictional separation of common carrier property and expenses between interstate and intrastate operations.”<sup>158</sup> This Joint Board, composed of three FCC commissioners and four commissioners of state regulatory commissions appointed by the National Association of Regulatory Utility Commissioners (NARUC), makes recommendations to the FCC concerning separations procedures.<sup>159</sup> The FCC, however, retains the ultimate authority to decide which procedures to adopt.<sup>160</sup> For example, in *Hawaiian Telephone*, the HPUC determined rates by using a different procedure than that adopted by the FCC.

### 3. *National Association of Regulatory Utility Commissioners v. FCC—Inside Wiring*

*National Association of Regulatory Utility Commissioners v. FCC*,<sup>161</sup> (“*Inside Wiring*”), was the first of three decisions issued by the D.C. Circuit in the summer of 1989. *Inside Wiring* was a follow-up case to *Louisiana Public Service*, in which the FCC sought to change the method of depreciating inside wiring costs. In *Inside Wiring*, the FCC sought to deregulate, or “detariff,” the maintenance and installation of inside wiring.<sup>162</sup> The FCC preempted the states from regulating inside wiring costs, arguing that such regulation would impede the FCC’s goal of a fully deregulated, competitive inside wiring market.<sup>163</sup> The FCC asserted that inside wiring was not a common carrier service and that sec-

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157. *Id.* at 1278 (Ferguson, J., dissenting).

158. 47 U.S.C. § 410(c) (1988).

159. *Id.*

160. *Id.*

161. 880 F.2d 422 (D.C. Cir. 1989) (this case is commonly referred to as *Inside Wiring*).

162. *Id.* at 426. Inside wiring refers to the telephone wires that are located on a customer’s premises, whether in a residence or a business. Inside wiring is subject to dual regulation since it is used for both intrastate and interstate communications service.

163. *Id.*

tion 152(b) was only applicable to common carrier services.<sup>164</sup> Secondly, the FCC claimed that, even if section 152(b) was applicable, inside wiring was not severable into interstate and intrastate components.<sup>165</sup>

The D.C. Circuit rejected the FCC's arguments that section 152(b) was not a bar to preemption. Following *Louisiana Public Service*, the court held that the plain language of section 152(b), "in connection with intrastate communication service," does not limit the states to regulating only common carrier services.<sup>166</sup> The court also rejected the FCC's claim that inside wiring was not separable into intrastate and interstate components. The FCC claimed that where it has detariffed the installation and maintenance of inside wiring, the costs of such services are no longer subject to the jurisdictional separations process.<sup>167</sup> The court rejected this analysis as circular, which would lead to "unchecked authority to force state deregulation of any activity [the FCC] chose to deregulate at the interstate level."<sup>168</sup>

Finally, the court held that where separation of dual jurisdiction property was "a practical and economic impossibility,"<sup>169</sup> the FCC, when acting within its statutory authority, could preempt state regulation which would negate "the exercise by the FCC of its own lawful authority."<sup>170</sup> The court also found that section 151 of the Communications Act gave the FCC the necessary authority to promote its policies of deregulation and competition, invoking the FCC's ancillary jurisdiction.<sup>171</sup> Under this highly deferential analysis, the court held that "the FCC may preempt inconsistent state regulation so long as it can show that the state regulation negates a valid federal policy."<sup>172</sup> Thus, the court reversed its position and based its decision on the negation of the FCC's exercise of authority instead of applying the "practical and economic impossibility" test.<sup>173</sup> The court held that the FCC could arguably preempt state requirements for bundling inside wiring and basic services because it might negate federal policy, but stated that "[t]he FCC has the burden . . . of showing with some specificity" that such regulations would negate the federal policy of competition.<sup>174</sup>

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164. *Id.* at 428.

165. *Id.* at 426-27.

166. *Id.* at 428; 47 U.S.C. § 152(b) (1988).

167. *National Ass'n of Reg. Util. Comm'rs*, 880 F.2d at 428.

168. *Id.* at 429.

169. *Id.* (citing *North Carolina Utils. Comm'n v. FCC*, 552 F.2d 1036, 1043 (4th Cir.), *cert. denied*, 434 U.S. 874 (1977)).

170. *Id.*

171. *Id.* at 429-30.

172. *Id.* at 431.

173. *Id.* at 429.

174. *Id.* at 430.



*Inside Wiring* is consistent with *FM Subcarrier* in limiting the FCC to preempting state regulation only to the degree necessary to prevent negation of the FCC's authority to regulate interstate activity. However, there are several problems with the D.C. Circuit's decision. First, the D.C. Circuit based the validity of the FCC's policies on the FCC's broad regulatory authority under section 151, a finding contrary to *Louisiana Public Service* and *FM Subcarrier*. In *Louisiana Public Service*, the Supreme Court explicitly rejected the FCC's reliance on section 151 to provide the authority to preempt the state's use of inconsistent depreciation methods.<sup>175</sup> In *FM Subcarrier*, the D.C. Circuit rejected the FCC's similar reliance on the broad language of section 301 as a statutory basis for preemption.<sup>176</sup> The *Inside Wiring* court should have followed *Louisiana Public Service* and *FM Subcarrier* to reject section 151 as a basis for preemption. Despite this departure from *Louisiana Public Service* and *FM Subcarrier*, the *Inside Wiring* court followed the merit of those cases by placing the burden on the FCC to prove that state actions would negate the FCC's policy of creating a competitive telecommunications market.<sup>177</sup>

Second, the court used inconsistent language in *Inside Wiring*. In the paragraphs following its decision to restrict the FCC to preempting only state regulations that would "negate" its authority, the court seemed to equate "interfere with," "thwart," and "frustrate" with the term "negate."<sup>178</sup> In addition, the court shifts from an analysis of negation of FCC authority to the negation of FCC policy goals—a much more deferential analysis.<sup>179</sup> While *Inside Wiring* does place limits on the FCC's ability to preempt state regulation, the D.C. Circuit's inexact and inconsistent language creates the opportunity for courts to treat the FCC with greater deference than the Supreme Court may have intended.

#### 4. *Illinois Bell Telephone Company v. FCC—Sales Agency*

One month after the D.C. Circuit issued its decision in *Inside Wiring*, it decided another FCC preemption case. In *Illinois Bell Telephone Co. v. FCC*,<sup>180</sup> ("*Sales Agency*"), the party contesting the FCC's preemptive order was Ameritech, one of the seven BOCs. The case arose out of FCC orders concerning the relaxation of structural separation requirements for the provision of CPE and enhanced services by the BOCs and

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175. *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 370 (1986).

176. *California v. FCC*, 798 F.2d 1515, 1520 (D.C. Cir. 1986).

177. *National Ass'n of Reg. Util. Comm'rs*, 880 F.2d at 430.

178. *Id.*

179. *Id.*

180. 883 F.2d 104 (D.C. Cir. 1989) (this case is commonly referred to as *Sales Agency*).

AT&T following the break-up of AT&T.<sup>181</sup> The FCC required the BOCs to enter into sales agreements with independent CPE vendors to allow them the equal opportunity to earn commissions on the sale of CPE as the BOCs' own subsidiaries.<sup>182</sup> The FCC ordered this arrangement to reduce the likelihood that the BOCs would engage in cross subsidization by shifting the costs of CPE commissions to regulated services.<sup>183</sup> In addition, the FCC "preempted the states from imposing structural separation requirements, or any other regulations inconsistent with the FCC's nonstructural safeguards on the BOCs' marketing of CPE."<sup>184</sup>

In *Sales Agency*, Ameritech protested the FCC's decision to condition the lifting of structural separations requirements from the BOCs on the continuation of sales agency agreements with independent CPE vendors.<sup>185</sup> Ameritech argued that the FCC had no authority "to regulate the marketing of . . . purely intrastate services," contesting the FCC's authority to preempt state regulation in this area.<sup>186</sup> The court upheld the FCC's preemptive order by applying the rules developed by the D.C. Circuit in *Inside Wiring*.<sup>187</sup> Ameritech asserted that the FCC was regulating "purely 'intrastate' services such as Centrex."<sup>188</sup> Ameritech argued that the BOCs would incur additional costs "in connection with the sale of . . . Centrex [s]ervices" under the sales agency requirements for CPE.<sup>189</sup> The court found that Centrex service is not separable into interstate and intrastate components "so as to permit separate state and federal regulation of the manner in which these services are marketed jointly with CPE."<sup>190</sup> Following *Louisiana Public Service*, the court held that where it is impossible to separate these components, "federal regulation of the entire subject matter (which may include preemption of inconsistent state regulation) [is allowable] if necessary to fulfill a valid federal regulatory objective."<sup>191</sup>

In this decision, the court applied the principles of *Louisiana Public Service* more closely than it had in *Inside Wiring* by deciding the preemption issue under the inseparability exception in footnote four of *Louisiana*

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181. See *supra* notes 55-62 and accompanying text.

182. *Illinois Bell*, 883 F.2d at 107.

183. *Id.*

184. *Id.* at 108.

185. *Id.* at 107.

186. *Id.* at 108.

187. *Id.* at 115-16.

188. *Id.* at 112. Centrex is central office equipment for businesses that is owned and operated by the BOCs and located on BOC premises. Centrex is often marketed jointly with CPE.

189. *Id.*

190. *Id.* at 116.

191. *Id.* at 115.

*Public Service*, rather than determining whether state regulation would negate FCC policy. The court stated that "strict separation of state and federal regulatory spheres . . . would require construction of wholly independent intrastate and interstate networks and facilities."<sup>192</sup>

5. *Public Utility Commission of Texas v. FCC—ARCO*

The third FCC preemption case that was decided by the D.C. Circuit in 1989 was *Public Utility Commission of Texas v. FCC*,<sup>193</sup> ("*ARCO*") which involved a dispute between the Public Utility Commission of Texas (Texas PUC) and the FCC over a decision by the Atlantic Richfield Company (ARCO) to disconnect service provided by GTE Southwest and reconnect service with Southwestern Bell.<sup>194</sup> ARCO operates its own private microwave communications network, which connects its offices around the United States. However, ARCO must often obtain connecting trunk line service from local monopoly service providers to connect its local offices to its private network. In this case, ARCO had leased trunk lines from GTE to provide service from its Plano, Texas laboratory to its private network, and similar lines from Southwestern Bell to connect its Dallas private branch exchange (PBX) to its private network.<sup>195</sup> When ARCO became dissatisfied with GTE's service, ARCO found it could use its private network to transmit calls from its Plano laboratory to locations outside of Plano, by first transmitting to its Dallas PBX and then through Southwestern Bell.<sup>196</sup> GTE contested this action before the Texas PUC, asserting that Southwestern Bell violated a state law prohibiting provision of service by an uncertified utility in an area served by another utility.<sup>197</sup> The Texas PUC prohibited the arrangement between ARCO and Southwestern Bell, finding that the interconnection would result in "significant public detriment."<sup>198</sup> Upon petition by ARCO, the FCC declared the Texas PUC's action invalid.<sup>199</sup>

The D.C. Circuit upheld the FCC's preemption order because the Texas PUC interfered with ARCO's federal right to interconnect with the public interstate network.<sup>200</sup> Specifically, the court found the FCC's analysis reasonable, in that, because the trunk lines in question could

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192. *Id.* at 116.

193. 886 F.2d 1325 (D.C. Cir. 1989) (this case is commonly referred to as *ARCO*).

194. *Id.* at 1327-28.

195. *Id.* at 1328. GTE is certified by the state as the monopoly provider for the area surrounding Plano, whereas Southwestern Bell is the monopoly provider for the Dallas area.

196. *Id.*

197. *Id.* at 1328-29.

198. *Id.* at 1329.

199. *Id.*

200. *Id.* at 1330.

transmit both interstate and intrastate calls, it was *impractical* to separate the activity.<sup>201</sup>

It is not clear why the court relied on a lesser standard of inseparability than the *Louisiana Public Service* impossibility standard. Relying on its analyses in *Inside Wiring* and *Sales Agency*, the court held that "even when the equipment that the FCC wishes to regulate is used inseparably and interchangeably for intrastate and interstate calling, the FCC must limit its regulation to the interstate aspects if it can do so."<sup>202</sup> Finding that the FCC had sufficiently narrowed its preemption order to limit only state activity that would negate federal policy, the court upheld the FCC's action.<sup>203</sup> Apparently significant to the court's decision is the fact that ARCO sought interconnection with Southwestern Bell for calls placed outside of GTE's franchised area, yet retained GTE service within Plano.<sup>204</sup>

*Texas Public Utility* suggests that states may "protect ratepayers" from similar bypass actions "by imposing reasonable charges for termination of service to minimize the impact of stranded investment."<sup>205</sup> *Texas Public Utility* has been viewed as allowing greater competition in the local exchange market, which has traditionally been a monopoly service.<sup>206</sup> *Texas Public Utility* relies heavily on *Inside Wiring* and *Sales Agency* in limiting the FCC's preemptive power by requiring the FCC to demonstrate to the courts that preemption is necessary to achieve its policy goals under the Communications Act. However, *Texas Public Utility* may be limited to its facts because it primarily concerns bypass of the local exchange and, therefore, is not likely to be used as precedent in FCC preemption analysis.

#### D. Impossibility and Inseparability—The Rule

The federal courts of appeals have restricted the FCC's preemptive power following the Supreme Court's decision in *Louisiana Public Service*, but not enough to slow the FCC's campaign to deregulate the telecommunications industry. The decisions in the above cases reveal that the courts are willing to give great deference to the FCC's policies despite the Supreme Court's admonition that in performing preemption analysis, courts must look to the statutory basis and congressional intent rather than to whether the FCC's policies are being negated. The rule resulting

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201. *Id.* at 1333-34.

202. *Id.*

203. *Id.*

204. *Id.* at 1335.

205. *Id.*

206. Haring & Levitz, *supra* note 99, at 320.

from these cases is that the FCC may preempt state action where it is not possible to separate the subject matter into distinct intrastate and interstate components and where, due to inseparability, state action may negate the federal policy of competition.

### III

#### *California v. FCC*

In *California v. FCC*,<sup>207</sup> petitioners, the CPUC, the Michigan Public Service Commission (MPSC), the New York Public Service Commission (NYPSC), a number of other state regulators, MCI Telecommunications Corp. (MCI), and NARUC, sued the FCC in the Ninth Circuit Court of Appeals. The petitioners contested the *Computer III Order* and the FCC's decision to preempt the states from (a) regulating intrastate and local enhanced services, and (b) imposing structural separations or non-structural safeguards that are inconsistent with the safeguards adopted by the FCC. Several intervenors, including AT&T, IBM, and the BOCs, filed briefs in support of the FCC. While petitioner MCI claimed that the FCC acted arbitrarily and capriciously in approving nonstructural safeguards in its *Computer III Order*, petitioners CPUC, MPSC, and NYPSC argued that the FCC had no authority under the Communications Act to preempt the states from regulating intrastate enhanced services or adopting structural safeguards or inconsistent nonstructural safeguards.<sup>208</sup>

The Ninth Circuit issued its decision on June 6, 1990 and found for the petitioners on all grounds.<sup>209</sup> A majority of the court held that the FCC acted arbitrarily and capriciously under section 10(e) of the federal Administrative Procedure Act, 5 U.S.C. § 706 (2)(A) by adopting non-structural safeguards in the *Computer III Order*.<sup>210</sup> More importantly, a unanimous court held that the clear language of the Communications Act precludes the FCC from preempting the states from regulating intrastate enhanced services or requiring structural safeguards or nonstructural safeguards that are inconsistent with FCC policies.<sup>211</sup> While the bulk of the decision addresses the court's analysis of the FCC's arbitrary and capricious actions, this Note focuses on the court's analysis of, and

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207. 905 F.2d 1217 (9th Cir. 1990).

208. See generally Supplemental Brief of Petitioners, MCI Telecommunications Corp., *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

209. *California v. FCC*, 905 F.2d 1217, 1246 (9th Cir. 1990).

210. *Id.* at 1238. The court found that "the record yields no support for the Commission's position that market and technological changes . . . have reduced the danger of cross-subsidization by the BOCs." *Id.*

211. *Id.* at 1240, 1242-45.

decision on, the preemption issues. The arguments of the petitioners and the FCC are presented below, followed by the court's decision.

### A. The Parties' Arguments

The petitioners raised two preemption issues in *California v. FCC*: (1) whether the FCC has the authority to preempt state regulation of intrastate and local enhanced services and (2) whether the FCC has the authority to preempt state regulations imposing structural separation or nonstructural safeguards, which are inconsistent with, or more stringent than, the FCC's safeguards.<sup>212</sup> However, the FCC phrased the first issue very differently.<sup>213</sup> The FCC simply asked whether it had the authority to preempt state regulation of enhanced services without distinguishing between intrastate and interstate enhanced services.<sup>214</sup>

#### 1. FCC Preemption of Intrastate Enhanced Services

In addressing the first preemption issue, the FCC argued that section 152(b) does not bar it from preempting state regulation of enhanced services. The FCC asserted that "[e]nhanced services, by settled definition, are not common carrier services."<sup>215</sup> Arguing that section 152(b) only denies the FCC jurisdiction over intrastate *common carrier* services, the FCC concluded that section 152(b) does not prevent it from preempting state regulation of enhanced services. The FCC asserted that the language of section 152(b) ("nothing in this chapter shall be construed to . . . give the [FCC] jurisdiction with respect to . . . intrastate communication service . . . of any carrier") indicated that Congress intended to limit

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212. Joint Opening Brief of Petitioners, The People of the State of Cal. & the Pub. Utils. Comm'n of the State of Cal. at 1, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases); Joint Reply Brief of Petitioners, the People of the State of Cal. & the Pub. Utils. Comm'n of the State of Cal. at 11, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

213. In addition to addressing the preemption arguments, the FCC asserted a *res judicata* defense to the petitioners' claims. The FCC asserted that the D.C. Circuit determined in *Computer & Comm. Indus. Ass'n v. FCC* that the FCC may preempt state regulation of enhanced services. Brief for FCC at 43, 45-52, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases). The court rejected the FCC's argument, asserting that the petitioners in *Computer & Comm. Indus. Ass'n v. FCC* did not have a "full and fair opportunity" to litigate the claim" of preemption. 905 F.2d at 1245 (citing *Kremer v. Chemical Constr. Corp.*, 456 U.S. 461, 481-82 n.22 (1982)).

214. Brief for FCC at 43, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

215. *Id.* at 54. The FCC relied on the D.C. Circuit's approval in *Computer & Comm. Indus. Ass'n v. FCC* that enhanced services were not common carrier services subject to Title II regulation. *Id.* at 54-55.

state jurisdiction to intrastate common carrier services.<sup>216</sup> The FCC bolstered this argument by claiming that the language in section 152(b) parallels language in Title II of the Communications Act, which grants the FCC specific authority to regulate common carrier services.<sup>217</sup> Finally, the FCC asserted that it had jurisdiction over enhanced services under "ancillary jurisdiction,"<sup>218</sup> which allows the FCC to regulate those matters "reasonably ancillary to the effective performance of the Commission's various responsibilities."<sup>219</sup>

The petitioners argued that section 152(b) was a bar to FCC preemption of intrastate enhanced services. First, the petitioners argued that section 152(b) does not limit state jurisdiction to common carrier services.<sup>220</sup> The petitioners claimed that, after *Louisiana Public Service*, states were guaranteed jurisdiction under section 152(b) over intrastate communication services provided by telephone companies, including services "for or in connection with" intrastate service.<sup>221</sup> Second, the petitioners disputed the FCC's claim that similar language in Title II of the Communications Act showed that Congress intended to limit state regulation to common carrier activities. The petitioners asserted that section 152(b) denies the FCC jurisdiction over intrastate services, while Title II sets forth the FCC's specific regulatory powers over interstate services.<sup>222</sup> The petitioners asserted that "[a]doption of the FCC's construction of this section would reduce [the] language [of section 152(b)] to mere surplusage."<sup>223</sup>

The petitioners also disputed the FCC's assertion that a common carrier that provides enhanced services is no longer a common carrier.<sup>224</sup> The petitioners argued that common carriers were "subject to state regulation, even if they offered intrastate non-common carrier services."<sup>225</sup> Finally, the petitioners argued that the FCC "has failed to demonstrate

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216. *Id.* at 57; Supplemental Brief of FCC at 7-8, 10-14, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases); 47 U.S.C. § 152(b) (1988) (emphasis added).

217. Brief for FCC at 62-63, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases); Supplemental Brief of FCC at 7-9, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

218. See Brief for FCC at 73-77, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

219. *United States v. Southwestern Cable Co.*, 392 U.S. 157, 178 (1968); see *supra* notes 103-05 and accompanying text.

220. Joint Opening Brief of Petitioners at 12-25, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

221. *Id.* at 17.

222. *Id.* at 16-17.

223. *Id.* at 17-18.

224. *Id.* at 18.

225. *Id.* at 21.

that the regulation of carrier-provided intrastate enhanced services is reasonably ancillary to its regulation of carrier-provided interstate regulated services under Title II."<sup>226</sup> The petitioners argued that Title II and section 151 do not provide a sufficient statutory basis to give the FCC ancillary jurisdiction over intrastate regulation of enhanced services.<sup>227</sup>

## 2. *FCC Preemption of State Structural and Nonstructural Safeguards*

The FCC argued that, even if the court found that section 152(b) applied to noncommon carrier services, such as enhanced services, it had the authority to preempt structural separations imposed by the states and nonstructural safeguards that were inconsistent with the FCC's safeguards.<sup>228</sup> The FCC asserted that under *Louisiana Public Service* it could preempt state action where it was not possible to separate the subject matter into intrastate and interstate components.<sup>229</sup> The FCC believed that it would be practically impossible to separate interstate enhanced services from intrastate services without requiring carriers to duplicate their equipment at great cost and inefficiency.<sup>230</sup> The FCC asserted that any inconsistent state practices would negate the effect of federal nonstructural safeguards and frustrate the federal policy of competition in the enhanced services market.<sup>231</sup>

The petitioners contended that section 152(b) prohibits the FCC from regulating intrastate "practices," "facilities," and "regulations," and that the FCC may not preempt the states from imposing structural separations or inconsistent nonstructural safeguards on those who provide purely intrastate and local enhanced services.<sup>232</sup> The petitioners also contested the FCC's claim that separation of interstate and intrastate enhanced services would be so impracticable as to be impossible. In contrast to the FCC, petitioners fully explained this argument, supplying a complete description of how interstate and intrastate enhanced services could be provided under federal structural safeguards and state structural safeguards, respectively.<sup>233</sup> The petitioners refuted the FCC and BOCs' argument that inconsistent state safeguards would interfere with

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226. *Id.* at 27.

227. *Id.* at 27-30.

228. Brief for FCC at 85, 88, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

229. *Id.* at 78.

230. *Id.* at 79.

231. *Id.* at 83.

232. Joint Opening Brief of Petitioners at 37, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

233. *Id.* at 41-44, addendum B; Supplemental Brief of Petitioners, MCI Telecommunications Corp. at 22-24, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).



the federal goal of an integrated and competitive enhanced services market, stating that the petitioners were concerned with regulation of intrastate and local enhanced services, not with regulation of the interstate enhanced services market over which the FCC has jurisdiction.<sup>234</sup>

## B. The Ninth Circuit's Decision

The Ninth Circuit found for the petitioners on all grounds.<sup>235</sup> A majority of the court (Judges Norris and Farris) found for petitioners MCI and NYPSC on the claim that the FCC acted arbitrarily and capriciously under the Administrative Procedure Act in approving the *Computer III Order*.<sup>236</sup> Judge Boochever joined Judges Norris and Farris in a unanimous decision denying the FCC the preemptive power to prohibit state regulation of intrastate enhanced services and state imposition of structural safeguards or inconsistent nonstructural safeguards.<sup>237</sup>

### 1. FCC Preemption of Intrastate Enhanced Services

The court phrased the first issue as whether section 152(b)(1) of the Communications Act, which denies the FCC jurisdiction with respect to "charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any carrier," . . . distinguishes between basic and enhanced telecommunications services."<sup>238</sup> The court simply read section 152(b) to include enhanced services: "the broad language of [section 152(b)(1)] makes clear that the sphere of state authority which the statute 'fences off from FCC reach or regulation,' . . . includes, at a minimum, services that are delivered by a telephone carrier 'in connection with' its intrastate common carrier telephone services."<sup>239</sup>

The court rejected the FCC's argument that section 152(b) does not apply to enhanced services because the section does not apply to non-common carrier services and enhanced services are noncommon carrier services.<sup>240</sup> The court further stated that the language "of any carrier" means that the statute distinguishes "between *providers* of communica-

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234. Joint Opening Brief of Petitioners at 47, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases); Supplemental Brief of Petitioners at 25-28, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (No. 87-7230 and consolidated cases).

235. *California v. FCC*, 905 F.2d 1217, 1246 (9th Cir. 1990).

236. *Id.* at 1238, 1246.

237. *Id.* at 1242-46.

238. *Id.* at 1239 (quoting 47 U.S.C. § 152(b)(1) (Supp. V 1982)).

239. *Id.* at 1240 (quoting *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 370 (1986)).

240. *Id.* ("That these enhanced services are not themselves provided on a common carrier basis is beside the point. As long as enhanced services are provided by communications carriers over the intrastate telephone network, the broad 'in connection with' language of [§ 152(b)(1)] places them squarely within the regulatory domain of the states.").

tions services, *i.e.*, between carriers and non-carriers.”<sup>241</sup> The court followed the D.C. Circuit’s *Inside Wiring* decision, which rejected the FCC’s attempt to preempt state regulation of intrastate inside wiring.<sup>242</sup> The FCC had characterized inside wiring as a noncommon carrier service, and thus not subject to section 152(b). The D.C. Circuit criticized the FCC for attempting “to rewrite” the Communications Act.<sup>243</sup>

The Ninth Circuit was not required to follow the D.C. Circuit’s decision. It could have developed its own tests and standards. However, had the court accepted the FCC’s arguments, it would have shifted all regulatory authority over enhanced services to the FCC. Such a decision would remove a layer of protection for consumers by shifting regulatory accountability from a body more able to address local and universal service concerns to a remote, overworked agency. The court’s interpretation of section 152(b) presents a strong message to the FCC that it does not have exclusive authority over telecommunications policy.

## 2. *Inseparability of State and Federal Regulations*

Regardless of how the court decided the common carrier issue, it was also necessary to determine whether the FCC could preempt the states from adopting structural separations or nonstructural safeguards that differed from those adopted by the FCC. The impossibility exception to section 152(b), set forth in footnote four of *Louisiana Public Service*, is the key to this preemption question. In *Louisiana Public Service*, the Supreme Court adopted part of the *North Carolina Utilities* exception to section 152(b), acknowledging that where it is impossible “to separate the interstate and the intrastate components of the asserted FCC regulation,” the FCC may preempt state regulation.<sup>244</sup>

The Ninth Circuit recognized the impossibility exception to section 152(b) but held that the exception was “a limited one.”<sup>245</sup> The court measured “impossibility” of the coexistence of state and federal regulations by evaluating the extent to which state regulations might frustrate federal policies. The court again relied on the D.C. Circuit’s *Inside Wiring* decision, adopting the rule that “‘a valid FCC preemption order must be limited to [state regulation] that would necessarily thwart or impede’ the FCC’s goals[,]” and that the FCC must show “‘with some speci-

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241. *Id.* (emphasis in original).

242. *Id.* at 1242.

243. *Id.* (quoting *National Ass’n of Reg. Util. Comm’rs v. FCC*, 880 F.2d 422, 428 (D.C. Cir. 1989)).

244. *Louisiana Pub. Serv. Comm’n v. FCC*, 476 U.S. 355, 375 n.4 (1986).

245. *California v. FCC*, 905 F.2d 1217, 1243 (9th Cir. 1990).

ficity that [state regulation] would negate the federal policy. . . ."<sup>246</sup> Thus, the court held that the FCC may not preempt all state regulatory action by showing only that "some of the preempted state regulation would, if not preempted, frustrate FCC regulatory goals."<sup>247</sup> The court found that the FCC did not sufficiently limit its preemption orders in the *Computer III Order* and that the FCC went too far when it sought to preempt all state structural separation regulations.<sup>248</sup> The court noted that the states could adopt structural separation requirements for "purely intrastate" activities, such as "alarm services and database services for schools," without interfering with FCC regulation of interstate enhanced services.<sup>249</sup> While the FCC asserted that structural separations would require the separation of all facilities, the court relied on the petitioners' claims that intrastate enhanced services and basic services could be provided by separate corporations, while using the same equipment.<sup>250</sup> The court also rejected the FCC's attempt to preempt all state nonstructural safeguards that are inconsistent with, or more stringent than, those established by the FCC, finding that the FCC did not fully explain what goals state regulation would frustrate.<sup>251</sup>

In this decision, the Ninth Circuit successfully staved off the FCC's attempts to preempt state regulation of intrastate telecommunications. However, the impossibility standard applied by the Ninth Circuit constitutes the only weak link in the court's reasoning. While the *Inside Wiring* test of impossibility limits the ability of the FCC to preempt state regulation of intrastate telecommunications services, it does not limit the FCC as fully as *Louisiana Public Service* would allow. The Ninth Circuit is not required to follow the D.C. Circuit. The Ninth Circuit could have decided "impossibility" under its own standard by applying a stricter test requiring the FCC to prove that state regulations would truly "negate" FCC regulations, rather than following the D.C. Circuit's lesser standard that calls for the FCC to show only that state regulation frustrates, thwarts, or interferes with FCC policy. For now, however, the states have retained their authority to regulate intrastate telecommunications under the Communications Act.

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246. *Id.* (quoting *National Ass'n of Reg. Util. Comm'rs*, 880 F.2d at 430) (emphasis in 905 F.2d at 1243).

247. *Id.* at 1243.

248. *Id.*

249. *Id.* at 1244.

250. *Id.*

251. *Id.* at 1245.

#### IV

#### Recommendations for the Future

Under *Louisiana Public Service*, courts must look to congressional intent in the language of the Communications Act to decide FCC preemption cases. While the Communications Act does not always provide clear answers for reviewing courts, it is clear that courts must not interpret the Act in a way that will nullify section 152(b). Until Congress amends the Communications Act, this section remains a valid expression of Congress's intent to grant the states a role in making telecommunications policy.

Since only Congress can effectively relieve the present tension between the states and the FCC concerning dual jurisdiction matters, this Note recommends an amendment to the Communications Act that would ameliorate jurisdictional disputes, without eliminating section 152(b). Congress should amend the Communications Act to describe specifically the balance of power between the states and the FCC, especially as to dual jurisdiction matters.

To address the dual jurisdiction issue realistically, Congress should amend section 410(c) of the Communications Act to mandate the use of a Federal-State Joint Board when issues arise over dual jurisdiction property and services, and require the states and the FCC to negotiate regulations concerning dual jurisdiction matters within a modified Joint Board structure. As section 410 is currently drafted,<sup>252</sup> the FCC has the discretion to convene several different state advisory committees to assist the FCC in its policy-making activities. The statute provides for three different types of advisory committees: State Joint Boards,<sup>253</sup> State Commissions,<sup>254</sup> and Federal-State Joint Boards.<sup>255</sup> State Joint Boards are composed entirely of state commissioners from those states affected by a particular FCC action.<sup>256</sup> State commission conferences are convened to discuss specific regulations.<sup>257</sup> Federal-State Joint Boards, composed of four state commissioners and three FCC commissioners, make recommendations to the FCC concerning jurisdictional separations.<sup>258</sup>

The FCC has convened a state-federal Open Network Architecture Conference to prevent a similar conflict over the development of Open

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252. 47 U.S.C. § 410 (1988).

253. *Id.* § 410(a).

254. *Id.* § 410(b).

255. *Id.* § 410(c).

256. *Id.* § 410(a).

257. *Id.* § 410(b).

258. *Id.* § 410(c); see *supra* notes 158-60 and accompanying text.

Network Architecture requirements.<sup>259</sup> However, it is unclear from the statute what the authority and responsibilities of the Conference are. In addition, the FCC is under no statutory obligation to participate in Conference meetings, nor is it bound to adopt the decisions or recommendations adopted by the Conference.

Section 410(c) requires the FCC to create a Joint Board to develop separations procedures for the allocation of cost between intrastate and interstate components of dual jurisdiction property. However, the FCC has the discretion to create Joint Boards for "other matters, relating to common carrier communications of joint [Federal-State] concern."<sup>260</sup> Congress should remove the FCC's discretion in this area and amend section 410(c) to require the FCC to convene a Federal-State Joint Board prior to *any* FCC rulemaking proceeding involving dual jurisdiction matters subject to section 152(b).

The House Subcommittee on Telecommunications and Finance held hearings in March 1990 to discuss a draft bill developed by subcommittee staff. The draft bill would lift some of the line-of-business restrictions that the Modified Final Judgment imposed on the BOCs.<sup>261</sup> The draft bill proposes that a Joint Board, composed of an equal number of FCC commissioners and State commissioners, recommend regulations to lift Modified Final Judgment restrictions on the offering of information services by the BOCs.<sup>262</sup> While this proposal is limited to Modified Final Judgment line-of-business restrictions, it is significant that House members consider the Joint Board process a meaningful way to develop FCC regulations.<sup>263</sup>

In addition, section 410(c) should be amended to require the FCC to develop regulations concerning dual regulation matters through a Joint Board using the negotiated rulemaking process. Under this process, an unspecified number of the Joint Board appointees would negotiate the

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259. *In re Filing and Review of Open Network Architecture Plans*, *Memorandum Opinion and Order*, 4 FCC Rcd. 111, paras. 216-19 (1989); Haring & Levitz, *supra* note 99, at 319 n.152. The Open Network Architecture Joint Conference has met twice already. See FCC Announces First Meeting of the ONA Joint Conference, *Public Notice*, 4 FCC Rcd. 5793 (1989); FCC Announces Second Meeting of the ONA Joint Conference, *Public Notice*, 4 FCC Rcd. 8220 (1989).

260. 47 U.S.C. § 410(c) (1988).

261. Telephone interview with Kevin Joseph, Staff Assistant, House Subcomm. on Telecommunications and Finance (Feb. 28, 1990); STAFF DISCUSSION DRAFT, TELECOMMUNICATIONS POLICY ACT OF 1990, 101st Cong., 2d Sess. (1990) [hereinafter DRAFT BILL]; see also Killette, *Free-the-Bells Bill Released*, COMMUNICATIONS WEEK, Feb. 12, 1990, at 8.

262. DRAFT BILL, *supra* note 261, § 257(d), at 44. Interestingly, the draft bill recommends that the BOCs offer such services only through separate subsidiaries. *Id.* § 254.

263. Although the draft bill was never introduced in the 101st Congress, Committee staff will actively pursue the Bill in the 102d Congress. Telephone interview with Colin Cromwell, Staff Assistant, House Subcomm. on Telecommunications and Finance (Oct. 24, 1990).

dual jurisdiction issue and draft a proposed rule, which would then follow the traditional requirements of the Administrative Procedure Act for notice and comment rulemaking.<sup>264</sup> "Negotiated rulemaking" is a process that the Administrative Conference of the United States (ACUS) recommended in 1985 for agency use to resolve disputes between agencies and parties affected by regulations before a rule is developed, instead of resolving their differences in the courts after the rule is issued.<sup>265</sup>

In negotiated rulemaking, the agency publishes a notice in the *Federal Register* announcing that it will conduct a negotiated rulemaking process.<sup>266</sup> The agency chooses a neutral "convenor" to organize the negotiation and work with the agency in deciding who will participate.<sup>267</sup> The agency may also appoint a mediator to lead the negotiations.<sup>268</sup> Whether or not a "negotiating group" arrives at a consensus on a proposed rule, the group prepares a report for the agency including the draft rules, or the areas of dispute.<sup>269</sup> The agency then publishes the negotiated proposed rule in the *Federal Register* and follows traditional notice and comment rulemaking procedures.<sup>270</sup> If the agency does not use the negotiated proposed rule, it must publish an explanation of its decision in the *Federal Register*.<sup>271</sup>

The ACUS Recommendation outlines several "factors" that should lead to better negotiations. These factors include that (1) issues be "ripe for decision,"<sup>272</sup> (2) participants not be required to compromise their fundamental beliefs,<sup>273</sup> (3) the number of participants be limited to no more than fifteen,<sup>274</sup> (4) a reasonable deadline for agreement be set,<sup>275</sup> (5) no one party "dominate the negotiations,"<sup>276</sup> (6) participants be willing to negotiate and "view it as in their interest to use the process as opposed

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264. 5 U.S.C. § 553 (1988).

265. Administrative Conference of the United States (ACUS) Recommendation No. 82-4, 1 C.F.R. § 305.82-4 (1989). ACUS Recommendation No. 85-5 adopted the term "negotiated rulemaking." See 1 C.F.R. § 305.85-5 n.1 (1989).

266. 1 C.F.R. § 305.82-4, Recommendations 1, 7 (1989); Harter, *Dispute Resolution and Administrative Law: The History, Needs, and Future of a Complex Relationship*, 29 VILL. L. REV. 1393, 1406 (1983-84).

267. 1 C.F.R. § 305.82-4, Recommendation 3 (1989).

268. *Id.* § 305.85-5, Recommendations 5, 10.

269. *Id.* § 305.82-4, Recommendation 11.

270. *Id.* Recommendation 13; Harter, *supra* note 266, at 1407.

271. 1 C.F.R. § 305.82-4, Recommendation 13 (1989).

272. *Id.* Recommendation 4(a).

273. *Id.* Recommendation 4(b).

274. *Id.* Recommendation 4(c).

275. *Id.* Recommendation 4(a).

276. *Id.* Recommendation 4(e).

to the traditional one,"<sup>277</sup> and, finally, (7) the agency be willing to negotiate.<sup>278</sup>

Negotiated rulemaking has been used by the Federal Aviation Administration, the Occupational Safety and Health Administration (OSHA), and twice by the Environmental Protection Agency.<sup>279</sup> While three of these negotiations were successful, the fourth, a negotiation by OSHA to establish a standard for occupational exposure to benzene, was not.<sup>280</sup> In addition, Congress recently enacted legislation that adopted a negotiated rulemaking procedure as a demonstration project to develop Department of Education regulations for elementary and secondary school programs.<sup>281</sup> However, Congress gave the Department of Education the authority to "select the participants" and to decide which regulations will be developed under the negotiated rulemaking procedure.<sup>282</sup> Thus, the Department of Education has more power under this legislation to set the rules and choose the players than in the negotiated rulemaking scheme developed by the ACUS.

The history of the Computer Inquiries shows that any rulemaking by the FCC concerning dual jurisdiction matters will be contested and reviewed in federal court, especially if the rule preempts state action. Negotiated rulemaking may provide the FCC, industry representatives, and state regulators with a means to hammer out their differences before they get to court. However, given the entrenched positions of the parties, several of the factors discussed above must be present for any negotiation in this area to be effective. First, the FCC and the states must be willing to negotiate. The parties will be more likely to seek a negotiated rulemaking if the outcome of the negotiation promises to be better than what they would achieve through the traditional court-contested rulemaking. Second, while the FCC has the upper hand in the traditional rulemaking process, it must not dominate a negotiated rulemaking.

It is not clear whether negotiated rulemaking of dual jurisdiction issues will be effective in reducing reliance on the courts to resolve disputes between the states and the FCC. However, combining the mandatory negotiation of dual jurisdiction issues with the Joint Board process will, at the least, give the states a greater role in setting telecommunications policy. Even if the parties cannot reach an agreement, the

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277. *Id.* Recommendation 4(f); Harter, *supra* note 266, at 1406.

278. 1 C.F.R. § 305.82-4, Recommendation 4(g) (1989).

279. 1 C.F.R. § 305.85-5 (1989); see Perritt, *Analysis of Four Negotiated Rulemaking Efforts*, 1985 A.C.U.S. 637 (1985).

280. 1 C.F.R. § 305.85-5 (1989).

281. Augustus F. Hawkins—Robert T. Stafford Elementary and Secondary School Improvement Amendments of 1988, Pub. L. No. 100-297, 102 Stat. 424 (1988).

282. *Id.* at 119.

process would be an improvement over the status quo since the states would be involved in the rulemaking process from the beginning, rather than having to respond to the FCC's final decisions. At best, negotiated rulemaking may result in a rule that will satisfy all parties and reduce reliance on the courts to arbitrate disputes between the states and the FCC.

## V

### Conclusion

While the FCC's policy goal of attaining a competitive telecommunications market is compelling, upholding the FCC's preemption orders in the *Computer III Order* would have nullified the dual regulatory scheme of section 152 of the Communications Act. Despite the Supreme Court's admonishment in *Louisiana Public Service* that courts must look to Congressional intent and not to the FCC's policy goals when engaged in preemption analysis, the federal courts of appeals have continued to defer to the FCC's policy decisions. Such decisions have diminished the effectiveness of section 152(b) in maintaining a role for the states in telecommunications regulation. The Ninth Circuit's decision in *California v. FCC* forces the FCC to acknowledge that the states are partners in the development of telecommunications policy.

The Ninth Circuit followed the lead of the D.C. Circuit in *Inside Wiring* and limited the FCC's preemptive power by requiring the FCC to prove that state structural separation requirements and nonstructural safeguards for intrastate and local enhanced services negate valid federal policy in order to preempt state regulation. A more deferential decision would have effectively eliminated section 152(b) from the Communications Act. Under *Louisiana Public Service*, only Congress may amend the Communications Act. Congress should amend the Communications Act to relieve the courts of the responsibility of deciding issues of dual jurisdiction. Such an amendment would provide the states with a more meaningful role in the rulemaking process.



